Absolute Return and Opportunistic Fixed Income Outlook

Authors

William H Eigen

Oksana Aronov

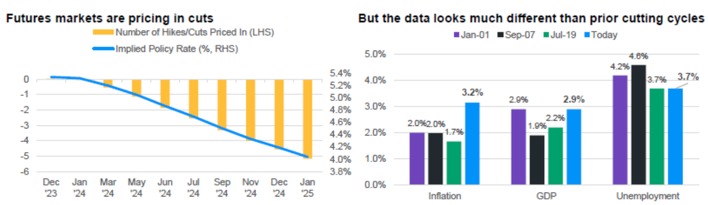
In Brief

- We came into 2023 with three counter-consensus view points: that inflation will prove stickier than expected, that the economy will prove more resilient than expected and that all of this will make high quality floating rate, and ultra short-term investments – as opposed to long duration - the best place to be. We maintain this view into 2024.
- We expect bond volatility to remain elevated in 2024 – due to both economic and technical factors. Unlike 2023 – this should start to produce meaningful cracks in credit, especially lower-rated - driving spreads wider, and creating attractive entry points for investors with optionality like ourselves..
- The Fed Funds rate will remain in the high 4% to 6% range, with aggressive cuts currently priced into the market fading and the possibility of further tightening not entirely off the table
- Inflation, as measured by Core CPI will be stubborn at around 3% - well above the Fed's stated target, and may actually rise in 2H24 - keeping easing in check.
- The above bodes well for our flexible, go anywhere approach to fixed income investing which has been focused on absolute return and – we expect – will transition into its more aggressive opportunistic mode in 2024.
- Risks to the above views exist, but are mitigated by the significant benefits of high quality carry and dry powder currently in portfolios. Should there be an exogenous shock to the system, necessitating a dramatic pivot for the Fed; or should there be an extended period of "soft landing" with dampened volatility – all will create unique opportunities for investors to capitalize on from a short and long standpoint to varying degrees.

Inflation and economy will prove more resilient than currently expected:

In late 2023 (similar to late 2022!) investors grabbed tight onto the hope of dramatic Fed cuts. This hope seems to hinge on the belief that once the Fed is done hiking – which the consensus maintains has happened – it will transition to cutting, as it has in prior hiking cycles. However, the economic fundamentals as we stand at the top of 2024 are starkly different from those in prior easing pivots (Exhibit 1.) And unless we see a dramatic deterioration in the economic data – a dramatic easing cycle is unlikely and bond investors may have simply pulled 2024 returns into 2023 via this aggressive pricing in of Fed cuts.

Exhibit 1: market hopes vs economic reality.

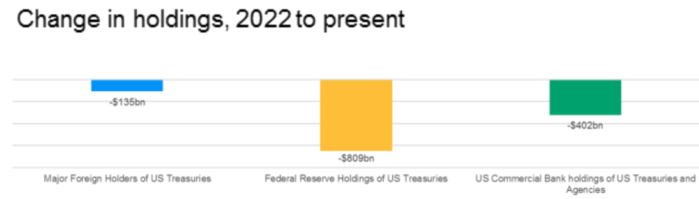


Source: Bloomberg; data as of 11/30/2023

Technicals not favoring Treasuries

Significant government spending deficits - $10T cumulative deficit spending over last 5 years – will continue to be a meaningful stimulus for the economy, as well as provide a floor to inflation. It is hard to see demands on the public purse subsiding in 2024 with geopolitical tensions requiring higher defense spending, while green energy initiatives, lower tax revenues, and higher cost of debt service – to name just a few – all requiring funding at a time when the three largest sources of demand for Treasury issuance are waning (Exhibit 2.)

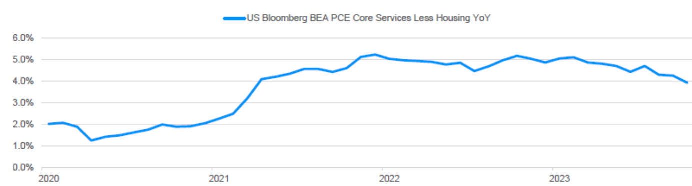
Exhibit 2: Treasury demand under pressure.



Source: Bloomberg; data as of 11/30/2023

The above, along with de-globalization may make for a much thornier path to the Fed's stated 2% inflation target, and actually keep inflation closer to 3%. Specifically, Core Services inflation has shown minimal improvement (Exhibit 3), since the Fed began hiking – and at 70% of Core CPI – lack of dramatic progress here means the Fed doesn't have the kind of direct knock-on effect it has on goods inflation. With oil prices in flux due to geopolitical tensions, and financial conditions easing dramatically into late 2023 and reducing the average mortgage rate – both energy and housing may see an acceleration, which combined with still very elevated services inflation backdrop – may lead to inflation ticking up in 2H24.

Exhibit 3: Core services inflation barely budging.

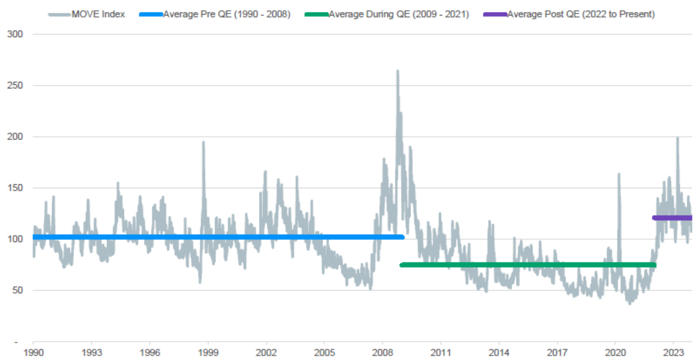


Source: Bloomberg; data as of 11/30/2023

Investors should brace for more bond volatility:

These economic and technical factors will keep bond volatility elevated (Exhibit 4), as prices grapple with technical and fundamental realities, without the soothing hand of central banks' quantitative easing.

Exhibit 4: Bond volatility remains at levels consistent with a world with no QE.

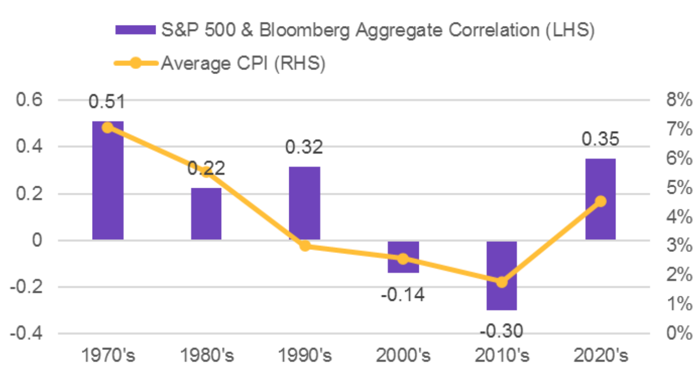


Source: Bloomberg; data as of 11/30/2023

Diversfication will be key for portfolios in a world of elevated inflation and bond volatility:

As the last couple of years demonstrated – diversification may not be there when you need it most! Traditional, interest rate driven, bond approaches have not provided the diversification vs. equities and other forms of risk in portfolios in 2022 or 2023 – instead moving up and down with equities. Positive bond/stock correlation is a feature of a world with elevated inflation (Exhibit 5) – and will continue to plague portfolios in 2024, especially now that the 10Yr Treasury has rallied to levels incongruent with the US economy's growth and inflation data.

Exhibit 5: As goes inflation – so goes stock / bond correlation.



Source: Bloomberg; data as of 11/30/2023

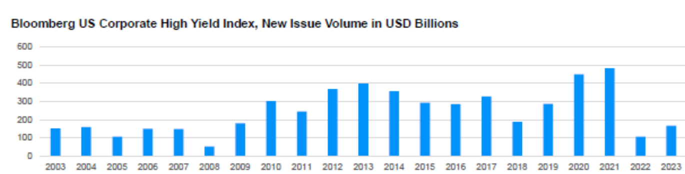
Potential for further appreciation for bonds here is very limited, *even if the Fed were to begin cutting some time in 2024.* This is because a) around 150bps of Fed easing is already priced in, and b) financial conditions easing in late 2023 equaling about 75bps of easing in itself. Any meaningful returns from here hinge on a dramatic recession or another source of economic shock.

Investors looking for diversification vs equities and fixed income, as well as the potential for a consistent, low volatility source of return – may consider looking to Absolute Return Fixed Income approaches which seek to deliver positive returns irrespective of interest rate directionality.

Credit default cycle is under way and will usher in a credit repricing:

With cost of capital remaining at a multi-year high (even in the event of a Fed cut) – lower-rated credit issuers will face unique challenges as they get closer to their 2025 maturity wall. Over the past year we have seen interest coverage ratios move down and leverage ratios move up in the High Yield market. We saw the beginning of a default cycle with High Yield bond and loan defaults moving up from 1% to 4% and nearly 6% respectively, according to Moody's research. And we've seen higher financing costs dramatically depress new issue volume in High Yield, making 2022 and 2023 the second and third lowest issue years since 2008 (Exhibit 6.)

Exhibit 5: As goes inflation – so goes stock / bond correlation.



Source: Bloomberg; data as of 11/30/2023

As the market begins to differentiate viable businesses from those unable to survive in this interest rate regime – we expect this to create opportunities for investors with liquidity and patience.

In summary:

Risks and volatility will continue to plague bond investors, while positive stock/bond correlation will complicate portfolio construction. Instead of trying to discern the path of interest rates – something that even the Fed itself has

J.P.Morgan ASSET MANAGEMENT

historically failed to do accurately – we subscribe to an absolute return fixed income investing approach. Not wedded to rate directionality, but instead emphasizing optionality to take advantage of various market repricings and stresses as 2024 unfolds.

Next steps

For more information, contact your
J.P. Morgan representative.

J.P. Morgan Asset Management

277 Park Avenue I New York, NY 10172

J.P.Morgan
ASSET MANAGEMENT